DOW THEORY LETTERS INC.

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THE MARKET: I know of only one way "to beat" a bear market, and that is to stay out of it. Day after day I receive Letters from subscribers, each of whom advances his or her own idea for scalping the trend. The leading reasons given for "having to invest now" are a fear of inflation or a fear of devaluation. I have stated before, and I will state again, that I do not think either of these will be a problem to investors in the period ahead. There is a good chance that inflation will turn into deflation over the next year or so. As far as devaluation is concerned, if it occurs within the framework of a bear market it will have little or no immediate effect on either investors or their assets. A surprise devaluation by Britain alone could exert pressure on the dollar and thus bring about financial trouble (and probably deflation) in the U.S. A world devaluation would mean that all nations had "marked up" the price of their gold reserves. Such a mark-up could lay the groundwork for future inflation, but if it came within a bear market, it would in all likelihood exert little influence on the price of stocks or anything else.

Think about this. A primary bear market has been in existence since February, 1966. But probably only a handful of seasoned investors grasp the full meaning of the primary bear trend. The primary trend, as Hamilton and Rhea so often pointed out, is the most powerful force in the market. The tidal (primary) sweep of the market can exert more pressure than the total resources of the Federal Reserve, the Bank of England, and all the other Central Banks of the world combined. To give an example, in the first six months of the bear market, according to U.S. News & World Report, the total value of U.S. securities decreased by $111 billion dollars. This is more than triple the total value of all mutual funds combined. Yet many still insist that the funds, by their buying, "can prevent a major collapse." On the face of it, the theory is absurd.

Here is another throught to consider. A number of months ago a new fund was started under the aegis of a man who was considered to be the shrewdest analyst and trader on Wall Street. So overpowering was this man's reputation that his fund was far oversubscribed when it was offered to the public. But on a reading last week that fund was down around 8% from issuing price. That means that if Mr. _____ had done nothing at all with his subscription money, if he had merely sat with cash (which, of course, he could not realistically have done), his shareholders would now be ahead. Even the fabulous Mr. ____ (and this in no way reflects on his ability) had not been able to beat the bear market. The best he can be expected to do is to outperform the market on the downside.

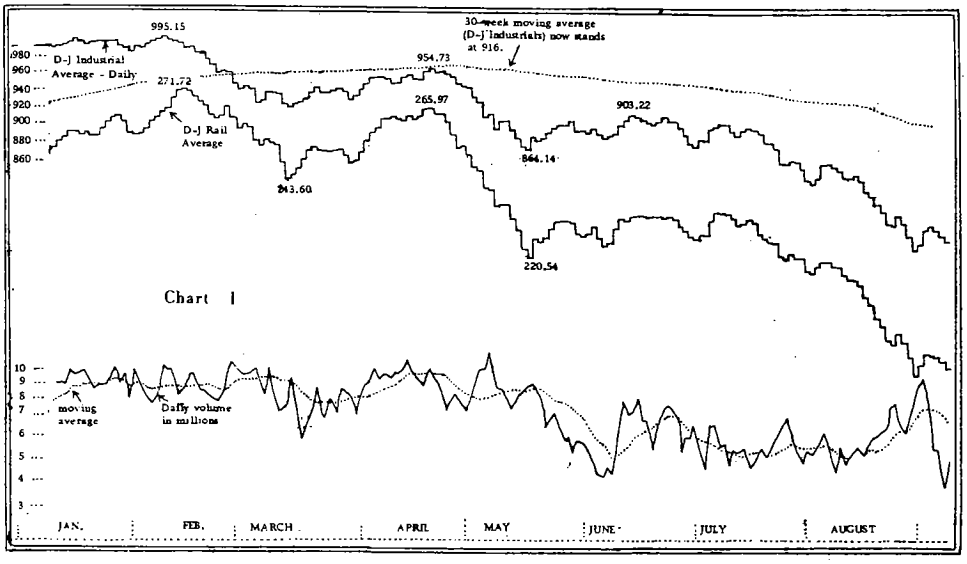
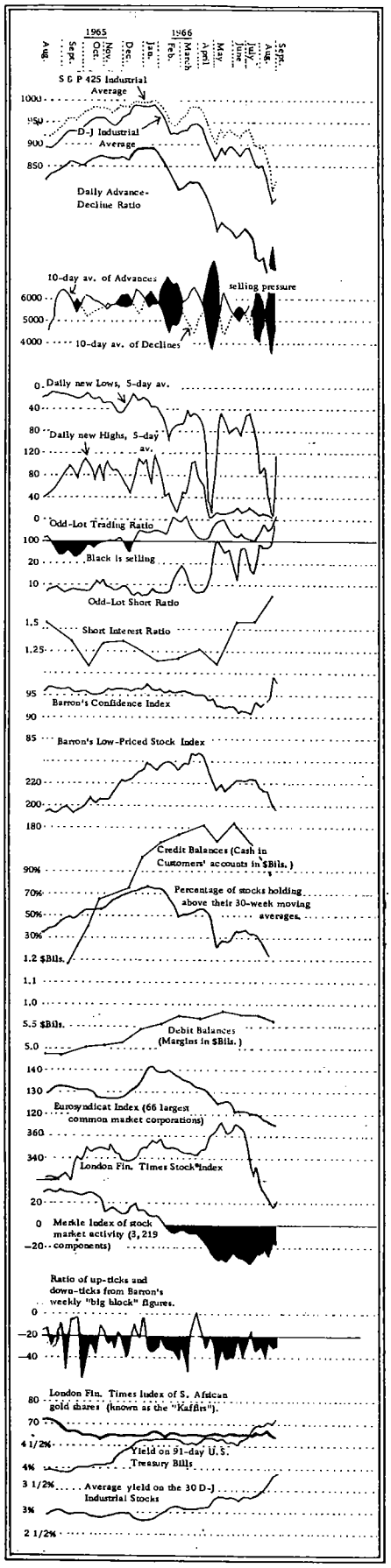


Chart I


1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily Advance-Decline Ratio
10-day av. of Advances
selling pressure
10-day av. of Declines
Daily new Lows, 5-day av.
Daily new Highs, 5-day av.
Odd-Lot Trading Ratio
Black is selling
Odd-Lot Short Ratio
Short Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Credit Balances (Cash in Customers' accounts in $Bils.)
Percentage of stocks holding above their 30-week moving averages.
Debit Balances (Margins in $Bils.)
Eurosyndicat Index (66 largest common market corporations)
London Fin. Times Stock Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's weekly "big block" figures.
London Fin. Times Index of S. African gold shares (known as the "Kaffirs").
Yield on 91-day U.S. Treasury Bills
Average yield on the 30 D-J Industrial Stocks

It is notable that each successive cave-in to new low levels by the Averages has brought out more volume and more "panicky" type action. There is no question about it, the nerves of stockholders, big and small, are becoming frayed. How much more can they take? Will they be able to hold on through "just one more plunge"? I rather think not. I feel, in view of the volume and action during the last break, that another smash to new lows could bring on the kind of market conditions that no one wants to see. Those conditions can only be described as "massive demoralization." Technicians and oracles have continually expressed the wish that a selling climax will develop. I believe that these gentlemen are thinking in terms of a selling climax of the 1957 or even the 1962 variety. But a primary bear market crash could be a horse (or bear) of a different color. If it occurs, I would wager that the "selling climax wishers" will have second and even third thoughts on the subject.

Meanwhile, the stock market is heading into the critical autumn period, the period when demand for money normally takes a sharp seasonal leap upward. The needs of the Vietnam war continue to put pressures on the money market. President Johnson appears content to sit by and watch the show. After all, he has been doing better with the Republicans than the Democrats in Congress, and he is under little pressure to relieve the monetary situation ("let the Federal Reserve and the Treasury sweat it out"). Washington, in general, seems to be immobilized by the coming elections, and it is doubtful whether Congress can be brought to do anything important on the money front until after the November election and most probably not until January when Congress convenes again. By that time, we could be deep in the midst of a money panic.

NOTES AND QUOTES: The latest Bank Credit Analyst (September) by A. Hamilton Bolton contains (as always) much of interest. Boton sees "...a continuation of deterioration pretty well across the monetary and credit scoreboard." In a particularly well documented study, Bolton notes that bear markets end after peaks in interest rates, not before or simultaneously with interest rate peaks. Using the yield on long-term U.S. Treasury bonds, Bolton shows that in 10 market declines of intermediate or major importance, the lag in market bottoms followed 4 to 12 months after the peak in interest rates. The average range of further depreciation in stock prices following interest rate peaks was 6% to 46%. If, for the sake of argument, interest rates peaked last week (and this cannot yet be proved), the bear market would probably still continue at least into the spring of 1967 with the Dow sinking perhaps to the 600 area. This should provide a warning for premature bulls, who are ready to jump into each bear market rally on the theory that "a new bull market has started."

Many subscribers have been wondering whether business is going to turn down in this bear market in line with my earlier forecasts. I believe it will, and that it has probably passed its peak already. Bolton shows bank debits (reflecting all financial transactions) now no higher than last spring, suggesting that financial activity probably "topped" last spring. However, commercial and industrial loans are continuing to rise to new highs. This relationship of debits to loans has thrust Bolton's debit-loans ratio into new low territory. If a small business keeps boosting its loans while its business (i.e. its actual sales) hold steady, it is going to run into trouble. Sooner or later, it is going to be over-loaned and over its head in inventory. Then comes the period of liquidation or bankruptcy. The same applies to a nation, and the debit-loan ratio indicates that liquidation of loans and inventory lies ahead. "By late fall," writes Bolton, "inventory accumulation should have turned to dis-accumulation and by early 1967 capital expenditures should feel the crunch of the monetary situation."

* * * *

I have opined that Hanoi is very much aware of our bear market and our monetary crisis. I have also stated that I felt that the odds on Hanoi asking for negotiations while this nation's stock market was in the throes of a bear market was almost nil. I continue to hold to that opinion, an opinion which was fortified by de Gaulle's recent pessimistic announcement following his meeting with Ho Chi Min's envoy. The fact is that Vietnam (probably on close advice and information from China) is using economics as its hidden ally. Subscribers who don't think that Vietnam and China are watching our market closely are simply dreaming.

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From Eliot Janeway's latest (August 31) Janeway Service: "No need to labor the point that the difference between a correction which builds a solid recovery base, and a break which disintegrates into panic, is determined by the degree of forced liquidation. Now that the shake-out in the market has shaken confidence, the phase of forced liquidation is at hand (while Washington is politically hors de combat). The big question now is whether the next break in the stock market, accompanied and accelerated as it will be by credit disturbances, by liquidity fears and by liquidation pressures, will induce shock therapy in Washington by January. The chances are not good. The situation will not correct itself. The present round of trouble started in Washington, and that is where remedies will have to start. None are anywhere in sight."

* * * *

From the Drew Odd Lot Studies, September 3, 1966: "We find that many want to consider this (i.e. odd-lot short sales) alone as a strong bull argument at this juncture, but they should note two things. As with so many technical market measurements, there is no way of knowing just 'how high is high'. The present level is certainly high by ordinary standards, but it will be seen that on the occasion of the 1962 decline, it was much higher. The only sure thing is that the short sellers will sell more the farther any given decline continues and will be selling most heavily at the bottom. Conceivably, a continued virulent decline later could result in a new record.

"The second qualification is that for a high rate of short selling to be taken as a strongly bullish factor, it should be accompanied by a trend toward the selling side in the overall figures of purchases and sales. As may be seen from the long-term chart, this is what happened during the important market base in the first part of 1958 and also in the fall of 1962 before important market uptrends. Therefore, we warn against placing any important reliance upon the current short selling alone. The figures have been high since April, but that has not prevented a declining price trend."

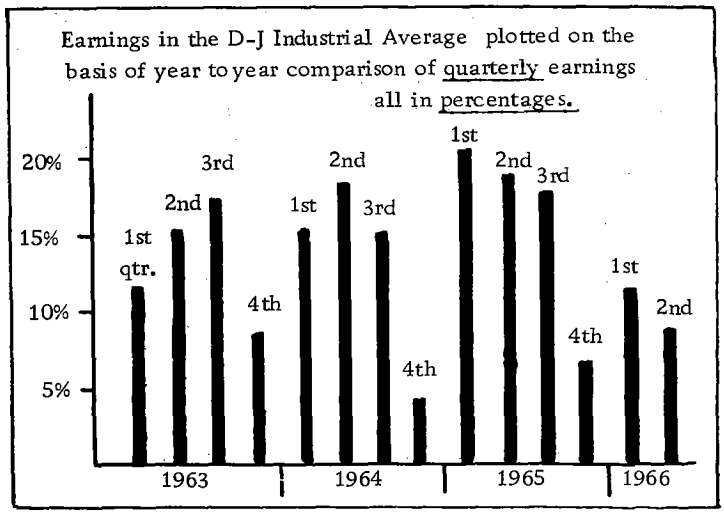
I have warned subscribers against jumping into every rally, and in the last Letter I wrote that during a bear market the only time that buying for the rise is justified is following a panic-crash. This has not yet occurred, although on the recent decline to the August 29 low (Dow 767.03) all the elements of a crash except volume were present.

A rally set in following the August 29 low. The rally continued during August 30, 31 and September 1, followed by declines on September 2 and 3. Two things were noteworthy about the rally. First, volume tended to dry up as stocks advanced. Second, odd-lot buying surged during the rally, suggesting that the public accepted the rally as "the turn." Although it is normal for odd-lotters to buy the first day or so of a rally following a sharp sell-off, it seemed to me that the heavy odd-lot purchases continued beyond the normal "rebound period," and this type of buying on the part of the public represents negative technical action. Therefore, although anything can happen in the period ahead I remain sceptical about the August 29 "bottom." Subscribers might keep a careful eye on the odd-lot figures during the week ahead. Continued buying on balance would further suggest that the public is loading up here while informed interests continue to liquidate. Subscribers should also study the volume characteristics in this area. As stated in my current (September 5) Barron's article on bear market rallies, "Dullness following the peak of a bear market rally is a common danger sign." Many bear market advances end on dullness and (or) the formation of a horizontal "line" in the Averages.

EARNINGS: In the last Letter I included a chart showing the quarterly comparisons of the Gross National Product. In terms of percentages, the GNP was evidencing a decelerating growth rate. If that deceleration continues as a trend, the GNP can be expected to

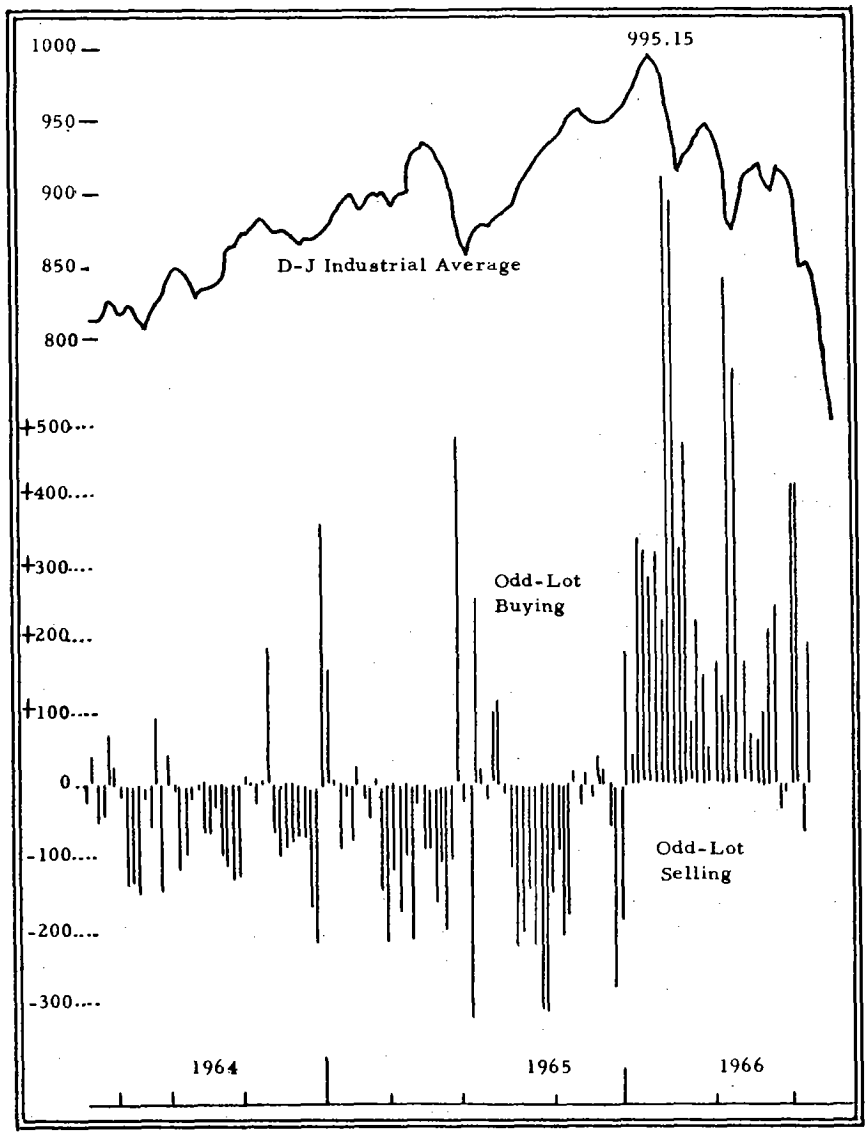
decline in the period ahead.

The accompanying chart shows the quarterly earnings on the D-J Industrial Average based on year to year comparisons (in percentages). Thus, as seen on the chart the first quarter of 1963 showed a 12% gain over the first quarter of 1962, the second quarter of 1963 showed a 16% increase over the second quarter of 1962, and so on.



The interesting thing to note on this chart are the comparisons, as they come in, for 1966 over 1965. So far, the first quarter 1966 gains are far below the first quarter 1965, and the same is true for the second quarter 1966. Third quarter results are likely to continue the decelerating growth rate, due mainly to a projected decrease in auto profits and a drop in the earnings of the three Dow oil companies (a result of the airline strike). I would expect earnings next year (with the advent of new corporate taxes) to show an actual drop over 1966. This is undoubtedly one of the factors which is being discounted by the bear market.

LONG-TERM ODD LOTS: The accompanying chart traces the official S.E.C. weekly balances of odd-lot transactions since 1964. If the weekly odd-lot buying was greater than selling, then it appears on the chart as a vertical line above zero. If selling predominated, the week's transactions are shown as a vertical line below zero. The fact is that from 1962 to 1965 the odd-lot public remained generally on the selling side of the market. Since the market was rising more or less continually during this period, the odd-lot figures constituted a technical factor of strength. The logic was simple enough: if the market was rising in the face of steady public (odd-lot) selling, then someone else (other than the public) must have been doing the buying and sending the market higher. The "someone else" was the professionals, the funds and the even-lot buyers in general.

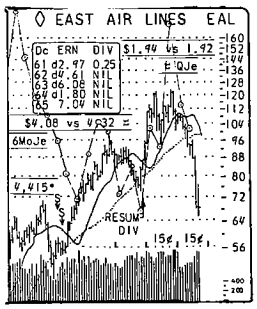


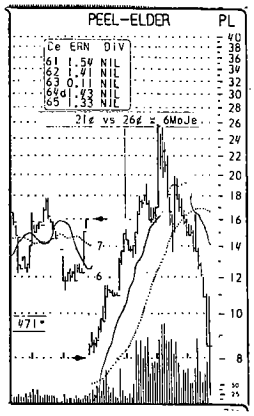
But during 1966 a definite switch took place in odd-lot sentiment. As the Dow approached 1000, as it became generally accepted that 1000 was "in the bag," the public turned bullish and began buying on balance. Even more bearish from a technical standpoint, the public began accepting market dips, not as the beginning of potential trouble, but as heaven-sent opportunities to buy. Here we can apply the reverse logic. If the (odd-lot) public was buying on declines, if the economic news was so rosy, if 1000 on the Dow was only "a matter of time," then who was doing the selling? The answer, unfortunately, is that professional money was unloading stocks even while the odd-lotters were eagerly picking up shares on every dip. Sensing trouble ahead, seasoned investors were getting out of the market and selling their stock to the public as fast as the public would buy them. Over 1 billion shares were traded in the area above 930 on the Dow. It may be a long time before the "over 930 buyers" see their money again.

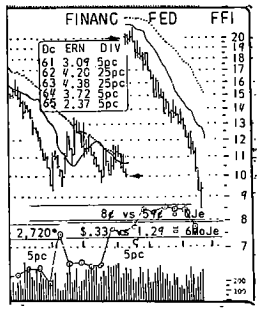
MR. MUNN'S ERROR: Many people who would not dream of shorting a primary bull market are ready with their cash in their fists, needing only the slightest encouragement in order to buy today's "bargains." What is a bargain in a bear market? I have just finished rereading a fascinating book entitled "Meeting the Bear Market." It was written in late-1930 by Glenn Munn. The book is particularly interesting because it is an intelligent and scholarly work dedicated to the thesis that after the horrendous collapse of 1929, stocks in 1930 must be on the bargain counter. The book provides a marvelous lesson because the author was such an excellent student and because his arguments were so convincing. There was, in fact, only one problem. Munn was dead wrong. The primary bear trend continued on from 1930 into July, 1932, and the market ultimately lost 80% (!) of its late-1930 value.

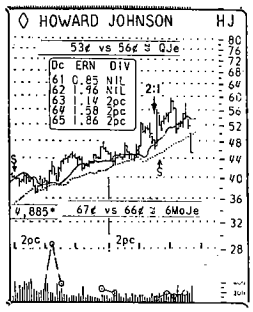
"When the maelstrom subsided on November 13, 1929," wrote the hopeful Munn, "stocks were stripped of the excess values obtained by use of fanciful multipliers. Once more the price-earnings ratio of representative groups returned to the 1926 level of approximately 8 times earnings. U.S. Steel could be bought for 7 times earnings against 13 times earnings on September 3, 1929; American Can for 8.6 times earnings against 18 times; International Harvester for 9 times earnings against 20 times. Yields had generally doubled."

The case was convincing; where did Munn go wrong? First, he erred in believing that a one-year bear market could correct the excesses of a giant 8 year bull market. But more importantly, he allowed the wish to be father to the thought. He did not realize that mighty booms can be followed by mighty collapses. While it is true that a long list of blue-chip stocks were subject to dreadful beatings during late 1929 and 1930, Munn did not foresee the possibility that stocks would go from depressed levels to "unbelievably depressed levels." Munn was not willing to let the primary bear trend run its course. What are the indications when a bear has terminated? I will discuss this in succeeding Letters.









APOLOGY: I have been inundated by a flood of "personal problem" letters over the last few weeks. In the past I have always answered all letters received here. Now, for the first time, I have to "throw in the sponge." I feel badly about this since many are long-time subscribers of five years or more. But in fairness to ALL subscribers, I have to bow out. It requires thought, research and energy to answer each letter, and I simply do not have enough energy and staying power to answer individual subscribers and do my "homework" for these Letters. I must read dozens of magazines, reports and mailings each week in the preparation of these Letters, and if I am to continue to do the job I want to on Dow Theory Letters, I am going to have to stop, at least for the time being, on answering personal correspondence. Again, my apologies.

STOCKS: Many individual stocks are now showing evidence of panic-crash action. As a rule, the more speculative the issue, the shorter the distributive top, and the more violent the collapse during a bear market. In Letter 327 (June 29) I remarked of the then-glamorous airlines, "If the market slides badly, I do not believe the Airlines will even produce distribution formation. They could simply go into 'one-day reversal formations' and start diving." This is what has occured, as shown by the chart of Eastern Airlines. The one-day reversal is typical of stocks which are held in weak or speculative hands. When the primary bear force hits, the weak holders "throw their shares in," and the result is a collapse unprefaced by any of the classic distribution formations. We see this type of action on hundreds of Amex stocks as examplified by Peel-Elder, which has lost two-thirds of its value in a period of a few months.

In other issues, issues which are receiving the brunt of currently unfavorable news, the velocity of the collapse has been breath-taking. Financial Federation, a leading savings & loan issue, typifies the "direct news" variety of cave-in, and here we see FFI dropping from 20 to 8 in a matter of a few months. Although FFI was far off its high at 20, the recent decline has been horrendous in terms of percentages, and the stock is now valued at one-tenth its all-time high price of a few years ago.

Another phenomenon of a primary bear market is what I term "catch-up action." This is shown on the chart of Howard Johnson. Here we see a stock which had held up well during the decline, but it should be remembered that two things occur during bear markets: (1) Price earnings for all stocks are adjusted downward. (2) Fundamentals change, and companies which previously had seemed immune to adversity are suddenly "re-analyzed" in the light of changing economic conditions. Thus Howard Johnson, after holding well up to a few weeks ago, suddenly smashed downward in harmony with the primary bear trend. There are few shining stars in real bear markets. (Charts courtesy of Quote Digest, 110 North Lorraine, Wichita, Kansas).

LATE NOTES: (Written Thursday, September 8, after the opening)....The averages are within easy striking distance of their August 29 lows of 767.03 (Industrials) and 190.48 (Rails) respectively. We should know shortly whether these lows are fated to hold or not. Yesterday the Amex Exchange Average broke to a new bear market low, and this being a primary bear market, I would guess that the Dow Averages will follow in due time. Volume implications can be exceedingly deceptive (and often useless) during a primary bear market, and many analysts are now taking hope in the low volume on the decline. Let's just watch the August 29 lows and see whether they hold. Remember, stocks usually require good volume to mount a broad advance— but they can fall of their own weight.